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SUBJECT: Regulators' Vague Signals and Inflation Policies Causing
Uncertainty for South China's Foreign Banks

REF: A) 07 Guangzhou 850, B) 07 Shanghai 504

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¶1. (SBU) Summary: To incorporate locally, or to remain a foreign branch, that is the question for south China's international banks. Bank of Montreal, Bank of America and other foreign banks are concerned by what they see as unclear government signals that could lead to future losses if banks fail to correctly interpret vague instructions. Clearly one concern is whether unincorporated banks will have their market access reduced at some time in the future. Meanwhile, Citibank is clearly frustrated by the slow progress in establishing full-service retail banking operations more than a year after regulators approved the launch of local subsidiaries by Citibank and British rival HSBC. The move by several small international banks to comply with China's regulators and establish onshore data processing is undermining the bargaining position of larger international banks. Bank executives and academics agree that inflation and hot money remain the primary concern of regulators, who have increased monitoring efforts to track capital inflows, particularly by scrutinizing joint venture investments and prepayments made to exporting companies. End Summary.

To Incorporate, or Not to Incorporate?

¶2. (SBU) In a recent meeting with Congenoff, Brendan Wong, the General Manager of Bank of Montreal's (BoM) Guangzhou Branch, said the toughest decision facing his bank is whether to incorporate as a local subsidiary. He explained that BoM has little internal motivation to do this, as the bank is focused on treasury operations and lending to multi-national companies, with no plans to establish retail banking in China. Wong added that BoM would have difficulty meeting the loan/deposit ratio requirements if it incorporated. At the same time, Wong said he is very concerned about the future direction of Chinese regulators; he complained that unincorporated foreign banks could have their market access reduced at some point in the future. Wong also said BoM would likely choose to incorporate if doing so were necessary to protect the bank's niche in this market. Unfortunately, his repeated requests that China's

regulators clarify what they want foreign banks to do have failed to elicit a specific answer.

¶3. (SBU) According to Bank of America's (BoA) Guangzhou Branch Manager, Andy Zhang, BoA views the issue of local incorporation similarly to Bank of Montreal. Zhang told us at a separate meeting that BoA has numerous reasons to remain unincorporated, including the cost of creating a separate back-end system for its China operations; the loan/deposit ratio requirements; and the likelihood that a subsidiary would have a lower credit rating than the parent bank. He asserted that operating as a foreign bank has no downsides for wholesale banking, which is all BoA seeks to do in China. (Note: BoA is contractually prohibited from retail banking as part of its strategic investment in China Construction Bank. End note.) Echoing Wong's concerns, Zhang acknowledged that failure to incorporate may ultimately become a disadvantage for BoA, depending on the future decisions of banking regulators.

Retail Banking Business Slow to Develop

¶4. (SBU) After successfully incorporating as a local subsidiary last year, Citibank has started offering retail banking services. Peter Qiu, the Guangzhou Branch Manager, expressed frustration, however, that the bank has so far been limited to investment services, such as deposits and QDII. Citibank currently cannot offer transactional services, including debit and credit cards, because the bank has not set up an onshore payments system as required by China's banking regulators. Qiu told us that most foreign banks had anticipated a grace period where they could offer card services while using offshore systems, but this has not been forthcoming. He expressed concern that several smaller international banks, including the Hong Kong-based Bank of East Asia, are rushing to comply with the wishes of the Chinese government, lessening the chance that a grace period

will ever be offered.

Inflation and Hot Money

¶5. (SBU) In separate meetings with bank executives, university professors, and financial reporters, all agreed that inflation and hot money remain the overriding concern of banking regulators. Citibank's Qiu and BoM's Wong told us separately that in recent months they have noticed much greater scrutiny by regulators of joint venture investments and prepayments made to exporting companies, a response to some of the most common tactics for skirting the PRC's capital inflow restrictions. BoA's Zhang said that he expects more and tighter restrictions to be implemented in the coming months. Dr. Lu Jun, chair of Sun Yat-sen University's Department of Finance, emphasized the historical significance of the government's inflation policies by describing both the fall of the Kuomintang (KMT, Nationalist Chinese) government in 1949 and the student protests leading to the 1989 Tiananmen Square incident as following periods of high domestic inflation.

¶6. (SBU) Despite the continued regulatory interest in hot money, each of the bankers we spoke with expressed skepticism about the actual volume of the inflows. Qiu questioned whether there are many people with a strong enough incentive to smuggle capital into the country, while Wong asserted that the central government is using hot money as a scapegoat for the current high level of inflation. Wong added that he doesn't trust official statistics; instead expressing his belief that the true level of inflation is considerably higher than figures reported by the government.

¶7. (SBU) In contrast, Luo Keguan, a journalist who covers the banking sector for south China's Southern Metropolis Daily, told Congenoff that hot money inflows are a serious problem and had heavily distorted the Shenzhen real estate market in recent years. He asserted that the ongoing slump in Shenzhen housing prices, which have fallen 23% over the last year according to a recent article in the Shenzhen Daily, is largely due to tightened regulations making it more difficult to buy property using speculators' hot money.

Comment

¶8. (SBU) It was clear that Citibank and many other foreign banks are unenthusiastic about China's requirements to establish onshore data processing systems and had hoped that a grace period would allow the banks to begin debit and credit operations that regulators would later decline to shut down. Qiu seemed irritated at Bank of East Asia for undercutting "Citi's and the other foreign banks' bargaining position" with its apparent willingness to comply with this regulation. This, combined with regulators' almost-obsessive fixation on reducing inflation and real - or perceived - hot money flows, is affecting how south China's foreign banks see their near- and mid-term prospects.

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